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Memorandum

Summary of Final Volcker Rule Regulation — Fund Activities

December 23, 2013

On Dec. 10, 2013, the Commodity Futures Trading Commission ("CFTC"), Federal Deposit Insurance Corporation ("FDIC"), Federal Reserve Board (the "Board"), Office of the Comptroller of the Currency and Securities and Exchange Commission ("SEC") (collectively, the "Agencies") issued a final rule (the "Final Rule") implementing Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which is commonly referred to as the "Volcker Rule."[1] The Volcker Rule restricts the proprietary trading and private investment fund activities of U.S. banks and their affiliates, as well as foreign banks with a branch or agency office in the United States and their affiliates (collectively, "banking entities").[2]

The text of the Final Rule is more than 70 pages long, while the supplemental guidance issued with it numbers nearly 900 pages and contains more than 2,800 footnotes. While the Final Rule is largely similar to the Notice of Proposed Rulemaking issued by the Agencies in 2011 (the "Proposed Rule"),[3] it does contain numerous important modifications from the Proposed Rule. As discussed below, banking entities generally have until July 21, 2015 to comply with the Final Rule's restrictions.

This *Memorandum* analyzes the Final Rule as it would affect a banking entity's investments in, or sponsorship of, private investment funds.[4] In this regard, the regulation has two parts. First, a banking entity is generally barred from acquiring or retaining, "as principal," an "ownership interest" in a "covered fund," subject to certain exceptions. Second, a banking entity may no longer "sponsor" any "covered fund," unless it abides by a series of new requirements (or the sponsorship falls within an exception for non-U.S. activity).

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[1] The Agencies, with the exception of the CFTC, issued a joint final rule release. The CFTC issued a separate, but virtually identical release.

[2] For the purposes of the Final Rule, the term "affiliate" means any company that controls, is controlled by or is under common control with another company. A company controls another company if: (i) the company directly or indirectly or acting through one or more other persons owns, controls or has power to vote 25 percent or more of any class of voting securities of the company; (ii) the company controls in any manner the election of a majority of the directors or trustees of the other company; or (iii) the Board determines, after notice and opportunity for hearing, that the company directly or indirectly exercises a controlling influence over the management or policies of the company. For purposes of the Final Rule, the term "affiliate" would not include any affiliated entity that is: (i) a covered fund; (ii) a portfolio company held by a bank, pursuant to its merchant banking authority; or (iii) a "portfolio concern" (as defined by 13 C.F.R. § 107.50) controlled by a "small business investment company" ("SBIC") (as defined in the Small Business Investment Act of 1958).

[3] The Agencies, with the exception of the CFTC, issued the Proposed Rule on Oct. 11, 2011. The CFTC issued its version on Feb. 14, 2012.

[4] An upcoming SRZ *Memorandum* will summarize the Final Rule's effect on proprietary trading. Moreover, we expect to release further and detailed guidance on specific aspects of the Final Rule's effect on funds and their managers, as well as host one or more presentations for our clients.

I. PROHIBITION ON FUND INVESTMENTS

A. What Is a "Covered Fund"?

As noted above, the Final Rule's prohibition on fund investments only pertains to *"covered funds."* Under the Final Rule, a "covered fund" includes:

1. Hedge or Private Equity Funds — The primary component of the definition of "covered funds" is any issuer that would be an investment company under the Investment Company Act of 1940 ("'40 Act") but for the exemptions contained in Sections 3(c)(1) and 3(c)(7) therein ("3(c)(1)/3(c)(7) funds");[5] and

2. Commodity Pool Equivalents — Certain Commodity Pools that are similar to 3(c)(1)/3(c)(7) funds are also included, specifically pools for which:

   (a) The commodity pool operator ("CPO") has claimed an exemption under CFTC Rule 4.7;[6] or

   (b) The CPO is registered with the CFTC and the pool is primarily held by qualified eligible participants ("QEPs") and has not been publicly offered to non-QEPs.[7]

3. Equivalent Non-U.S. Funds (*if banking entity is U.S. or U.S.-controlled*) — Moreover, for any *U.S. banking entity (or any non-U.S. banking entity that is directly or indirectly controlled by a U.S. banking entity)* a "covered fund" would also include any issuer that:

   (a) Is organized or established outside the United States;

   (b) Offers and sells its ownership interests outside the United States; and

   (c) Is, or holds itself out as, a vehicle for primarily investing or trading in securities (a "foreign fund");

   unless such foreign fund, were it subject to U.S. securities laws, could rely on an exemption from the '40 Act other than those contained in Section 3(c)(1) or 3(c)(7) therein.

   In contrast, a non-U.S. banking entity that is not directly or indirectly controlled by a U.S. banking entity would not have to treat a non-U.S. fund that meets the foregoing criteria as a covered fund (but, for this purpose, a U.S. branch or agency office of a non-U.S. bank would be treated as a U.S. banking entity).[8]

B. What Entities Are Excluded from the "Covered Fund" Definition?

The following types of issuers do not constitute covered funds under the Final Rule, even where they otherwise would fit the definition:

[5] This would capture nearly all entities currently thought of as hedge funds or private equity funds. However, the Final Rule appears to make clear that an issuer that can rely on exemptions under the '40 Act other than Section 3(c)(1) or 3(c)(7), such as a real estate fund relying on Section 3(c)(5), will not be treated as a covered fund, even if it may also rely on Section 3(c)(1) or 3(c)(7).

[6] The Agencies chose to include "Rule 4.7" pools in the definition since they are most similar to 3(c)(1)/3(c)(7) funds, as they are only offered to investors who meet certain heightened qualification standards.

[7] The Agencies chose to include such funds so as to prevent a CPO from choosing full CPO compliance, rather than rely on Rule 4.7 (even though eligible to do so), simply to keep the pool outside the scope of the Final Rule.

[8] For example, such a fund would be a covered fund with respect to a U.S. banking entity that sponsors the fund, but not be a covered fund with respect to a non-U.S. banking entity that invests in the fund (provided the entity is not U.S.-controlled). This bifurcated treatment of such non-U.S. funds, depending on the jurisdictional nature of the banking entity involved, is a significant change from the Proposed Rule and was meant to limit the extraterritorial effect of the Volcker Rule.

1. Certain Non-U.S. Public Funds — A public fund organized or established outside the United States, provided that:

   (a) It is authorized to offer and sell ownership interests to retail investors in its home jurisdiction; and

   (b) It sells such interests "predominantly"[9] through one or more public offerings outside the United States that: (i) comply with all applicable requirements in the applicable jurisdiction; (ii) are not restricted based on investor net worth; and (iii) include the filing of publicly available disclosure documents.

   (c) Moreover, *for any U.S. banking entity (or any non-U.S. banking entity that is directly or indirectly controlled by a U.S. banking entity)* to rely on this exemption to "sponsor" (as defined herein) a non-U.S. public fund, the fund's ownership interests must be sold "predominantly" to persons other than: (i) the banking entity; (ii) the issuer; (iii) their affiliates; or (iv) employees or directors of such entities.[10]

2. Certain Non-Funds — Three types of entities that would not normally be thought of as funds, but could otherwise sometimes fall within the broad definition of "covered funds":

   (a) Wholly Owned/Nearly Wholly Owned Subsidiaries — An entity that is at least 95 percent owned by a banking entity, provided that any amount not owned by the entity is held by: (i) employees or officers (not to exceed 5 percent); or (ii) third parties (not to exceed 0.5 percent) where such third-party investor is needed to establish corporate separateness or address bankruptcy or similar concerns;

   (b) Joint Ventures — A joint venture ("JV") between a banking entity and others, provided (i) there are no more than 10 unaffiliated co-venturers; and (ii) the JV vehicle does not invest, or hold itself out as investing, in securities for resale, but otherwise engages in activity that is permissible for the banking entity; and

   (c) Acquisition Vehicles — An issuer formed solely for the purpose of engaging in a bona fide acquisition or merger, which exists only for such period as necessary to effectuate such transaction.[11]

3. Foreign Pension Funds — A broad-based plan, fund or program organized and administered outside the United States to provide retirement or similar benefits, provided that it is: (i) subject to regulation in its home jurisdiction; and (ii) established for benefit of citizens or residents of one or more non-U.S. sovereigns (or subdivisions thereof).

4. Insurance Company Separate Accounts — Provided that no other banking entity besides the insurance company shares in the profits or losses of such account.

5. Bank Owned Life Insurance — Provided that the banking entity that purchases the policy does not: (i) control the investment decisions of the separate account; or (ii) participate in the profit or losses of such account, except in accordance with applicable supervisory guidance.

6. Loan Securitizations — An issuer of asset-backed securities ("ABS"), provided that its assets are solely comprised of:

[9] For the purposes of this exclusion "predominantly" means 85 percent or more of the fund's ownership interests.

[10] Accordingly, unlike with non-U.S. equivalents of 3(c)(1)/3(c)(7) funds, U.S. banking entities (and non-U.S. banking entities controlled by a U.S. banking entity) may be able to invest in or sponsor a non-U.S. public fund without such activity being subject to the Final Rule. However, the Agencies intend to monitor U.S. banking entities' investments in non-U.S. public funds to ensure such funds are not used to evade the Volcker Rule.

[11] However, an acquisition vehicle that survives a transaction may then be eligible for either of the two preceding exclusions.

(a) Loans (defined as any loan, lease, extension of credit or receivable, that is not a security or derivative);

(b) Any rights or other assets: (i) related or incidental to acquiring or holding the loans; or (ii) designed to assure the servicing or timely delivery of proceeds to the security holders ("Permitted Assets");

(c) Interest rate or foreign exchange derivatives that are directly related to the loans or Permitted Assets held by the issuer or related ABS and are specifically designed to reduce the interest rate or foreign exchange risks related thereto;

(d) Special units of beneficial interest and collateral certificates issued by a special purchase vehicle ("SPV"), provided that: (i) the SPV does not hold any assets impermissible for the issuer to hold; (ii) the interest or certificate is used solely to transfer to the issuer the economic risks and benefits of assets permissible for the issuer to hold (and does not transfer any interest in any other exposure); (iii) the interest or certificate is created solely to satisfy legal requirements or facilitate the structuring of the securitization; and (iv) both the SPV and the issuer are established by the same entity that initiated the securitization;

(e) Cash equivalents for the purposes of the Permitted Assets; or

(f) Securities received in lieu of a debt previously contracted with respect to the loans supporting the ABS.

Moreover, an eligible loan securitization may not hold any commodity forward contract or, except as permitted above, any securities (including ABS) or derivatives.

7. Certain Asset-Backed Commercial Paper Conduits — An issuer of asset-backed commercial paper ("ABCP") whose assets are solely comprised of: (i) loans and other assets permissible for an exempt securitization (as described above); or (ii) ABS supported solely by such assets and that were acquired by the ABCP issuer as part of an initial issuance either directly from the ABS issuer or from an underwriter, provided that:

   (a) The ADCP conduit issues only ABS comprised of a residual interest and securities with a legal maturity of no more than 397 days; and

   (b) A "regulated liquidity provider"[12] has a legally binding obligation to provide full and unconditional liquidity coverage with respect to the ABS issued by the conduit (other than any residual interest) in the event that funds are required to redeem maturing ABS.

8. Qualifying Covered Bonds — An entity holding a pool of loans or other assets permissible for an exempt securitization (as described above) for the benefit of holders of "covered bonds."[13]

9. SBICs and Public Welfare Investment Funds — An issuer that is: (i) an SBIC under the Small Business Investment Act of 1958 (or a company that has received a notice to proceed to qualify for such a license); (ii) "Designed primarily to promote the public welfare" under Section 24(Eleventh) of the National Bank Act; or (iii) a "qualified rehabilitation expenditure" with respect to a qualified rehabilitation building or certified historic structure under Section 47 of the Internal Revenue Code of 1986.

[12] "Regulated liquidity providers" include: (i) an FDIC-insured depository institution; (ii) a U.S. bank or savings and loan holding company (or any subsidiary thereof); (iii) a non-U.S. bank whose home country supervisor has adopted capital standards consistent with Basel III (or a subsidiary thereof); or (iv) the United States or a non-U.S. sovereign.

[13] For this purpose a "covered bond" means: (i) a debt obligation issued by a non-U.S. banking entity (or a subsidiary thereof), the payment of which is fully and unconditionally guaranteed by the entity holding the pool of loans or other assets; or (ii) a debt obligation of the entity holding the pool of loans or other assets, where such entity is a "wholly-owned or nearly wholly-owned subsidiary" (as discussed above) of a non-U.S. banking entity (or a subsidiary thereof) and such parent fully and unconditionally guarantees the payment of such obligation.

10. Registered Funds — An issuer that is: (i) registered as an investment company ("RIC") or regulated as a business development company ("BDC") under the '40 Act;[14] or (ii) formed pursuant to a written plan to become a RIC or BDC and, in the meantime, operates in compliance with the leverage requirements of the '40 Act.[15]

11. FDIC-Related Issuers — An issuer that is formed for the purpose of facilitating the disposal of assets acquired by the FDIC as receiver or conservator.

In addition to the foregoing, the Agencies may exempt other types of issuers in the future, if they make a public determination that such exclusions would be consistent with the purposes of the Volcker Rule.

C. What Are "Ownership Interests" of a Covered Fund?

As noted above, the Final Rule only prohibits acquiring or holding an *"ownership interest"* in a covered fund. The Final Rule defines an "ownership interest" to mean any equity or partnership interest or any other interest that exhibits any of the following features or characteristics on a current, future, or contingent basis:

1. Has the right to participate in the selection or removal of the covered fund's general partner, managing member, directors, trustees, investment manager, investment adviser or commodity trading advisor (although not including the remedial rights of a creditor upon the occurrence of an event of default or acceleration event);

2. Has the right to receive a share of the income, gains or profits of the covered fund;

3. Has the right to receive the residual assets of the covered fund (not including creditor rights, as discussed above);

4. Has the right to receive all or a portion of the excess spread (i.e., difference between the aggregate interest payments from the covered fund's underlying assets and the aggregate interest paid to holders of other outstanding interests);

5. Provides that the interest amounts payable by the covered fund could (as per the terms) be reduced based on losses arising from the underlying assets of the covered fund;

6. Receives income on a pass-through basis, or has a rate of return that is determined by reference to the performance of the underlying assets of the covered fund;[16] or

7. Any synthetic right to have, receive or be allocated any of the foregoing rights.

A restricted profits interest (e.g., carried interest) earned by a banking entity in its role as investment adviser (or as provider of other services) to a covered fund will *not* be deemed to be an ownership interest as long as the following conditions are met:

1. The sole purpose and effect of the interest is to allow the banking entity (or current or former employee thereof) to share in the profits of the covered fund as performance compensation for investment management, investment advisory, commodity trading advisory, or other services[17]

[14] Absent this exemption, such entities could have constituted covered funds, to the extent that they also fit the definition of a covered commodity pool.

[15] This includes an investment company which relies on Section 3(c)(1) or 3(c)(7) during its seeding period.

[16] "Ownership Interests" would therefore include a lending arrangement with a covered fund in which the interest or other payments are calculated by reference to the profits of the fund. However, this definition would generally not include a loan that provides for a step-up in interest rate margin when a covered fund has fallen below or breached a NAV trigger or other negotiated covenant. This provision is also not intended to encompass derivative transactions entered into in connection with typical prime brokerage activities of banking entities, provided such activites are not being used to evade the Volcker Rule.

[17] The Final Rule does not define the scope of such "other services," but the Agencies indicated that they would include acting, for example, as sub-advisor or placement agent.

performed for the covered fund, provided that the banking entity (or current or former employee) may be obligated to return profits previously received;[18]

2. All such profit, once allocated, is: (i) distributed to the banking entity (or current or former employee thereof) promptly after being earned; or (ii) retained by the covered fund for the sole purpose of establishing a reserve amount to satisfy contractual obligations with respect to subsequent losses of the covered fund, and the reinvested profit does not share in the subsequent gains of the covered fund;[19]

3. Any amounts invested in the covered fund in connection with obtaining the carried interest are, together with any other ownership interests in the fund held by the banking entity or its affiliates, within the limitations of the *De Minimis* Exception (or, if applicable, the Seeding Exception) and the Aggregate Limit (each discussed below);[20] and

4. The interest held by the banking entity (or current or former employee thereof) is not transferable except to an affiliate (or employee of the banking entity or an affiliate), to immediate family members, or through the intestacy of the employee or former employee, or in connection with the sale of the business that gave rise to the carried interest to an unaffiliated party that provides services to the covered fund.[21]

D. When Is a Banking Entity Acting "as Principal"?

As noted above, the Final Rule's prohibition only applies where a banking entity acquires or holds an ownership interest in a covered fund *"as principal."* The Final Rule clarifies the scope of acting "as principal" by stating that the prohibition *does not* apply to a banking entity's acquisition or holding of an ownership interest in a covered fund, where the banking entity acts:

1. Solely as agent, broker or custodian, so long as the activity is conducted for the account of, or on behalf of, a customer, and the banking entity and its affiliates do not have or retain beneficial ownership of the ownership interest;

2. Through a deferred compensation, stock-bonus, profit-sharing, or pension plan of the banking entity (or an affiliate thereof) that is established and administered in accordance with applicable U.S. or non-U.S. law, if the ownership interest is held or controlled directly or indirectly by the banking entity as trustee for the benefit of current or former employees of the banking entity (or affiliate);

3. In the ordinary course of collecting a debt previously contracted in good faith, provided that the banking entity divests the ownership interest as soon as practicable (and within such period permitted by its primary federal regulator); or

4. As trustee or in a similar fiduciary capacity for a customer that is not a covered fund, so long as the activity is conducted for the account of, or on behalf of, the customer, and the banking entity and its affiliates do not have or retain beneficial ownership of such ownership interest.

[18] Unlike the Proposed Rule, the Final Rule permits employees or former employees to retain carried interest after a change in employment status, so long as it was originally received for providing qualified services.

[19] This condition has been modified from the Proposed Rule to allow for a "clawback": where the carried interest could be taken back and remain in the covered fund, until the occurrence of subsequent events (i.e., reaching specified rate of return levels).

[20] This condition was added to the Final Rule so as to allow the investment adviser or others to hold small amounts of ownership interest for the purpose of achieving the desired tax treatment for carried interest.

[21] While the Final Rule did lessen the restrictions on transferability, the rights to the carried interest still cannot be freely transferrable.

E. What Are the Exceptions to the Investment Prohibition?

Under the Final Rule, a banking entity, even when acting as principal, may acquire or hold an ownership interest in a covered fund, without regard to the prohibition, under the following circumstances:

1. Funds "Organized and Offered" by the Banking Entity — A banking entity may invest in the ownership interests of any covered fund "*organized and offered"* by the banking entity or an affiliate, provided that certain per fund and aggregate limitations are satisfied. "Organizing and offering" a fund includes acting as "sponsor"[22] to the fund, but also includes other activities, such as serving as investment adviser (including sub-adviser), distributer, or broker to a covered fund. Accordingly, a banking entity may only use this exception to invest in covered funds with which it has such a relationship. Such investments are subject to the following:

   (a) Per-Fund Limit — The aggregate investments[23] of the banking entity and its affiliates[24] cannot exceed three percent of the total number or value of that fund's outstanding ownership interests (or, in the case of a covered fund that issues ABS, three percent of the fund's fair market value,[25] unless a greater percentage is required under the risk-retention requirements of section 15G of the Securities Exchange Act of 1934 (the "'34 Act")[26]) (collectively, the "*De Minimis* Exception").[27]

      (i) In the case of a master-feeder structure, the foregoing limit only applies at the covered master fund — any investments made directly in the master will be aggregated with a pro rata share of any interest held through the covered feeder fund.

      (ii) Similarly, in the case of a fund of funds, any direct investment in a covered fund will be aggregated with a pro rata share of any interest held through a covered fund of funds.

   Notwithstanding the foregoing, during the first year after a covered fund is "established,"[28] the banking entity and its affiliates may exceed the three percent limitation and own up to 100 percent of the covered fund's ownership interests, so long as it actively seeks outside investors during this period (the "Seeding Exception").[29] The Board may grant an extension of the Seeding Exception (not to exceed two years) requested by a banking entity, if such

[22] The term "sponsor," as discussed in more detail below, means: (i) serving as a general partner, managing member, commodity pool operator or as a trustee with investment discretion; (ii) selecting or controlling a majority of the directors, trustees, or management; or (iii) sharing the same name (or a variation thereof) with a covered fund.

[23] Funds that are committed by the banking entity, but not yet called, do not count towards the per-fund limitation.

[24] For this purpose a covered fund sponsored by the banking entity will not be considered an affiliate, so long as it is organized and offered in accordance with the Final Rule (as discussed later herein). RICs, BDCs and non-U.S. public funds will not be considered an affiliate, provided the banking entity provides its services in accordance with applicable law and does not control 25 percent or more of the voting shares of such vehicle.

[25] This is due to the fact that such entities do not have a single class of security and thus, the valuation of the ownership interests cannot be made on a per interest or single class basis.

[26] A banking entity may rely on any of the options available to it in order to meet the requirements of section 15G, but for purposes of the Volcker Rule, the amount held by the banking entity may not exceed the amount required under the chosen option.

[27] The *De Minimis* Exception is intended to allow a banking entity to demonstrate "skin in the game" to third-party investors. While many commenters on the Proposed Rule argued that a three percent limit is too low to achieve this purpose, the Agencies declined to increase the limit. Compliance with the *De Minimis* Exception must be measured as of the last day of each calendar quarter, except in the case of ABS issuers, where it should be measured as of the date of establishment (as defined below) or such earlier date on which the transferred assets have been valued for purposes of transfer to the covered fund, and thereafter only when additional securities of the ABS issuer are priced for purposes of the sale of ownership interests to unaffiliated investors.

[28] The Final Rule clarified that, for this purpose, a covered fund is deemed to be established on the date on which it begins to make investments. In order to account for the unique circumstances and manner in which securitizations are established, for a covered fund that is an issuer of ABS, the date of establishment is the date on which the assets are initially transferred into the issuer.

[29] While many commenters on the Proposed Rule argued that the one year period is often insufficient to build up a track record necessary to attract outside investors, the Agencies declined to increase the timeframe. However, they did reference the possibility of obtaining an extension from the Board in such cases.

extension would be consistent with safety and soundness and not detrimental to the public interest.[30]

(b) Aggregate Limit — The aggregate value of all covered fund ownership interests held by the banking entity and its subsidiaries cannot exceed three percent of the tier 1 capital of the banking entity (the "Aggregate Limit").[31] For this calculation, the aggregate value of such ownership interests is the sum of all amounts paid or contributed (including by an entity or employee in connection with a carried interest) on a historical cost basis.[32] Moreover, the Final Rule requires that the banking entity deduct from its tier 1 capital (for both the foregoing calculation and for measuring compliance with applicable U.S. regulatory capital requirements) the greater of: (i) the foregoing historical cost *plus* earnings; or (ii) the fair market value of such ownership interests, if the profits or losses of the investments were reflected on the entity's financial statements.[33]

The Proposed Rule also contained a provision intended to curb potential evasion of the foregoing per-fund and aggregate limitation through investments made outside, but parallel with, a covered fund. Specifically, the Proposed Rule provided that, to the extent that a banking entity is contractually obligated to invest in, or is found to be acting in concert through knowing participation in a joint activity or parallel action toward a common goal of investing in, one or more investments with a covered fund that is organized and offered by the banking entity (whether or not pursuant to an express agreement), such investment must be included in the calculation of a banking entity's per-fund limitation applicable to that fund. The Final Rule omitted this provision, but the Agencies indicated that a banking entity should not make any co-investment with a sponsored covered fund in a privately negotiated investment unless the value of such co-investment is less than three percent of the value of the total amount co-invested by other investors in such investment.[34]

2. Underwriting and Market Making — The Final Rule added a specific provision (similar to that already contained in the proprietary trading section of the Proposed Rule) allowing banking entities to hold ownership interests in covered funds when the entity is engaged in underwriting and market making-related activities of ownership interests in such funds, so long as:

   (a) The banking entity conducts the activities in accordance with the Final Rule's prohibition on proprietary trading;

   (b) Any covered fund ownership interests held by the banking entity and its affiliates pursuant to this exception are: (i) deducted from tier 1 capital (as discussed above); and (ii) within the Aggregate Limit (when aggregated with any other investments that are subject to the Aggregate Limit); and

[30] A banking entity must make any request for such an extension at least 90 days prior to the normal expiration of the Seeding Exception. In reviewing such a request, the Board may consider all relevant factors and facts, including: (i) whether the investment exposes the banking entity to high-risk assets or strategies; (ii) the contractual terms of the investment; (iii) the expected length of additional time necessary to attract sufficient outside investors; (iv) the banking entity's total exposure to the fund and the risks of maintaining, or disposing of, the investment to the entity or U.S. financial stability; (v) the cost of divesting the investment within the normal timeframe; (vi) any material conflicts of interest between the banking entity and any third-party to which it owes a duty that would result from approving or denying the request; (vii) the entity's prior efforts to reduce its ownership percentage; and (viii) market conditions.

[31] Measured as of the last day of each calendar quarter. If a banking entity is not required to calculate and report tier 1 capital, or is it directly or indirectly controlled by an entity that is so required, then tier 1 capital for this purpose is the total shareholder's equity for the entity's top-tier affiliate. While the Aggregate Limit must be calculated on a quarter-end basis, the Agencies expect banking entities to monitor their investments regularly and remain in compliance throughout the quarter.

[32] By requiring the use of historical cost, the Final Rule prevents a banking entity from increasing its exposure to covered funds in the event any particular covered fund investment declines in value.

[33] Therefore, profits resulting from investments in covered funds will not inflate the capital of the banking entity for U.S. regulatory compliance purposes. The Final Rule does not require a non-U.S. banking entity that makes a covered fund investment in the United States to deduct the aggregate value of the investment from the entity's tier 1 capital calculated under applicable home country standards.

[34] Further, if the co-investment is made through a co-investment vehicle that is itself a covered fund (a "co-investment fund"), the sum of the banking entity's ownership interests in the co-investment fund and the related covered fund should not exceed three percent of the sum of the total ownership interests in the co-investment fund and the covered fund.

(c) If the banking entity (or an affiliate thereof): (i) acts as a sponsor, investment adviser or commodity trading advisor to a particular covered fund; (ii) otherwise acquires and retains an ownership interest in the fund in relation to organizing and offering the fund; (iii) acquires and retains an ownership interest in the fund and is either a "securitizer,"[35] or is acquiring and retaining an ownership interest in the fund in compliance with section 15G of the '34 Act; or (iv) directly or indirectly guaranties or insures the obligations or performance of the fund or of any covered fund in which the fund invests,[36] then in each such case the value of any ownership interests held by the banking entity and its affiliates pursuant to this exception in that fund are permissible under the *De Minimis* Exception (or, if applicable, the Seeding Exception) and the Aggregate Limit (when aggregated with any other investments that are also subject to such limits).

3. Risk-Mitigating Hedging — The Final Rule permits a banking entity to hold an ownership interest in a covered fund in order to "demonstrably reduce" or "significantly mitigate" the "specific, identifiable" risks to the banking entity from a compensation arrangement with an employee (or an employee of an affiliate) that directly provides investment advisory or other services to that fund.[37] In other words, a banking entity may invest in a covered fund to hedge the risk associated with employee compensation that is tied to that fund's performance.[38] Notwithstanding the foregoing, a banking entity may not enter into any hedging investment that, at its inception, gives rise to any significant new or additional risk that is not, itself, hedged contemporaneously.

   (a) In order to avail itself of this exemption, a banking entity must have internal written policies and controls to ensure compliance with the Final Rule's requirements associated with such hedging activity.

4. Investments Made "Solely Outside the United States" — Certain eligible non-U.S. banking entities are permitted to hold ownership interests in certain eligible covered funds, so long as such activity occurs "solely outside the United States."

   (a) Eligible Banking Entities — In order for a banking entity to use this exemption, the following criteria must be satisfied:

      (i) The banking entity is not organized, or directly or indirectly controlled by a banking entity organized, in a U.S. jurisdiction (including any U.S. territory or commonwealth).[39]

      (ii) If the entity is a "foreign banking organization" under the Board's Regulation K, it qualifies for the exemption.[40]

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[35] As that term is used in section 15G(a)(3) of the '34 Act.

[36] This restriction does not prohibit a banking entity from entering into or providing liquidity facilities or letters of credit for covered funds; however, it would apply to arrangements such as a put of the ownership interest in the covered fund to the banking entity.

[37] The Final Rule appears to be more stringent, in this regard, than the Proposed Rule, which merely required that the investment be "designed to reduce the specific risks" associated with the compensation arrangement. More importantly, while the Proposed Rule contained an additional exemption allowing a banking entity to invest in a covered fund in order to hedge risk arising when the banking entity serves as an intermediary for a customer to facilitate exposure by such customer to the fund, the Agencies omitted this exemption from the Final Rule. Currently, such a practice typically occurs when bank customers choose to obtain exposure to a covered fund via a derivative issued to them by a bank (this is done for a variety of reasons, including obtaining leverage). In turn, the banking entity invests in the fund to hedge its exposure to the customer. However, since the Agencies omitted the proposed exemption designed to permit such hedging from the Final Rule, such investors will need to consider alternative arrangements.

[38] The compensation arrangement hedged under this exemption must relate solely to the covered fund in which the banking entity (or any affiliate thereof) has acquired an ownership interest, such that any losses on the ownership interest would be offset by corresponding decreases in the amounts payable under the compensation arrangement.

[39] Thus, non-U.S. subsidiaries or non-U.S. offices of a U.S. banking entity may not take advantage of this exemption. The disparate treatment of U.S. and non-U.S. banking entities is this regard is basically unchanged from the Proposed Rule. While numerous commenters on the Proposed Rule complained that it would impose a competitive disadvantage on U.S. banking entities, the Agencies indicated that, in addition to their being potential policy reasons to support such disparate treatment, they were bound by the express statutory language of the Volcker Rule.

[40] Under Regulation K, a "foreign banking organization" is a foreign bank that operates a branch office, agency office, commercial lending company, bank subsidiary or Edge corporation in the United States, or any subsidiary of such an institution. To constitute a "qualifying

(iii) If the entity is *not* a "foreign banking organization" under the Board's Regulation K, it must satisfy at least two of the following:

- Its total assets held outside the United States exceed those held in the United States;

- Its total revenues from its non-U.S. business exceed those from its U.S. business; or

- Its total net income from its non-U.S. business exceed that from its U.S. business.

(b) Eligible Covered Funds — In order for an eligible non-U.S. banking entity to invest in a covered fund under this exemption, the fund must not sell its ownership interests in any offering that targets "U.S. persons" (as defined under the SEC's Regulation S).[41] (It is important to note that the Final Rule does not appear to predicate eligibility on where the covered fund invests, where its investment manager is located, or even in what jurisdiction the fund is organized.)

(i) Master-Feeder Structures — A covered feeder fund that satisfies the foregoing will, nonetheless, not be eligible if the covered master fund it which it invests does not also satisfy the foregoing.

(c) Eligible Activity — In order for activity to occur "solely outside the United States" the following criteria must be satisfied:

(i) The eligible banking entity (or office thereof) acting as principal (and that makes the decision to engage in the activity, if different) is not organized or located in the United States.[42]

(ii) No relevant personnel of the entity responsible for the decision to engage in the activity is located in the United States (excluding "back office" personnel[43]);

(iii) The activity is not accounted for as principal, directly or indirectly, on a consolidated basis by a branch or affiliate organized or located in the United States; and

(iv) No financing is provided, directly or indirectly, by a branch or affiliate organized or located in the United States.

5. Insurance Company Investments — The Final Rule added a specific provision (similar to that already contained in the proprietary trading section of the Proposed Rule) allowing banking entities that are regulated insurance companies (and their affiliates) to hold ownership interests in covered funds if the investment:

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foreign banking organization," it must satisfy two tests (unless otherwise permitted by the Board). First, it must satisfy at least two of the following: (i) its banking assets held outside the United States exceed its total worldwide nonbanking assets; (ii) its revenues derived from the business of banking outside the United States exceed its total revenues derived from its worldwide nonbanking business; or (iii) its net income derived from the business of banking outside the United States exceeds its total net income derived from its worldwide nonbanking businesses. Second, it must satisfy at least two of the following: (i) its banking assets held outside the United States exceed its banking assets held in the United States; (ii) its revenues derived from the business of banking outside the United States exceed its revenues derived from the business of banking in the United States; or (iii) its net income derived from the business of banking outside the United States exceeds its net income derived from the business of banking in the United States.

[41] This is a more forgiving standard than that of the Proposed Rule, which appeared to turn solely on whether any of the fund's ownership interest were actually owned by any U.S. resident. Instead, in promulgating the Final Rule, the Agencies indicated that (absent circumstances otherwise indicating a nexus with U.S. persons), the sponsor of a foreign fund would not be viewed as targeting U.S. persons if it: (i) conducts an offering directed to non-U.S. residents; (ii) includes in the offering materials a prominent disclaimer that the securities are not being offered in the United States or to U.S. residents; and (iii) employs reasonable procedures to limit access to the materials to non-U.S. residents.

[42] For this purpose, any U.S. office of a non-U.S. bank (or any subsidiary of such office) is located in the United States, but the bank itself is not.

[43] The Agencies explained that this permits U.S. employees to provide administrative services or similar support functions (such as clearing and settlement, maintaining and preserving records, furnishing statistical and research data, or providing clerical support).

(a) Is held solely for the general account of the insurance company or for one or more separate accounts established by it; and

(b) Complies with the insurance law in which the insurance company is domiciled (and the appropriate Federal banking agencies have not determined that such law is insufficient to protect the banking entity's safety and soundness or the financial stability of the United States).

II. "PROHIBITION"[44] ON SPONSORSHIP OF FUNDS

A. What Does It Mean to "Sponsor" a Fund?

As noted above, a banking entity may no longer "sponsor" a covered fund, unless it abides by a series of new requirements on its relationship with such fund (or such sponsorship falls within the exemption for non-U.S. activity explained below). The Final Rule defines the term "sponsor" to mean:

1. Serving as a general partner, managing member, trustee (excluding trustees that do not exercise investment discretion[45]), or commodity pool operator of a covered fund;

2. Selecting or controlling, in any manner, a majority of the directors, trustees, or management of a covered fund; or

3. Sharing with a covered fund, for corporate, marketing, promotional or other purpose, the same name or a variation of the same name.[46]

However, sponsoring does not include other activities that may be part of organizing and offering a covered fund, such as merely acting as an investment advisor, sub-advisor, distributor, or broker to the fund.

B. Under What Circumstances May a Banking Entity Sponsor a Covered Fund?

A banking entity may sponsor a covered fund[47] in connection with "organizing and offering" such fund (as discussed above), provided that the following requirements are satisfied:

1. The banking entity must provide bona fide trust, fiduciary, investment advisory, or commodity trading advisory services.[48]

   (a) The covered fund must be offered only to persons that are customers of such services. However, such customer relationship need not be pre-existing or involve more than the relevant fund investment; the banking entity must merely demonstrate (through written documentation) that the fund is organized and offered for the purpose of providing one or more of the foregoing bona fide services to its customers (or those of an affiliate) and not for the purpose of evading the Volcker Rule.

2. No director or employee of the banking entity may hold an ownership interest in the covered fund, except for a director or employee who is directly engaged in providing investment advisory,

[44] While the Volcker Rule purports to "prohibit" a banking entity from "sponsoring" a covered fund, subject to certain exceptions, in a practical sense, it instead imposes a series of new requirements on a banking entity's sponsorship activities.

[45] Including a trustee that is subject to the direction of an unaffiliated fiduciary pursuant to section 403(a)(1) of the Employee's Retirement Income Security Act, or a trustee that is subject to fiduciary standards imposed under foreign law that are substantially equivalent to the foregoing.

[46] However, as indicated below, such name sharing is elsewhere prohibited by the Final Rule.

[47] Including a covered fund that is an ABS issuer.

[48] However, this requirement does not apply where the sponsored covered fund is an ABS issuer.

commodity trading advisory or other services[49] to such fund.[50] (However, directors or employees who received a permitted ownership interest may retain that interest after no longer serving in the same capacity.)

(a) However, any ownership interest purchased by a director or employee pursuant to a loan, guarantee or extension of credit by the banking entity will be attributed to the banking entity itself.

3. The banking entity must not hold an ownership interest in the covered fund (including any interest held by an employee or director that is attributed to the entity as explained above), except as consistent with the *De Minimis* Exception (or, if applicable, Seeding Exception) or Aggregate Limit.

4. The covered fund must not share the same name, or a variation of the same name, as the banking entity (or any affiliate thereof) for any purposes,[51] nor can it use the word "bank" in its name.

5. The banking entity (and its affiliates) must not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of the covered fund or of any covered fund in which such covered find invests.[52]

6. The banking entity must provide written disclosure to prospective and actual investors that clearly and conspicuously: (i) indicates that all investors should read the fund offering documents before investing; (ii) describes the role of the banking entity and its affiliates and employees in sponsoring or providing any services to the covered fund; and (iii) contains the following representations:

   (a) "Any losses in [such covered fund] will be borne solely by investors in [the covered fund] and not by [the banking entity] or its affiliates; therefore, [the banking entity's] losses in [such covered fund] will be limited to losses attributable to the ownership interests in the covered fund held by [the banking entity] and any affiliate in its capacity as investor in the [covered fund] or as beneficiary of a restricted profit interest held by [the banking entity] or any affiliate"; and

   (b) "Ownership interests in the covered fund are not insured by the FDIC, and are not deposits, obligations of, or endorsed or guaranteed in any way, by any banking entity" (unless that happens to be the case).[53]

7. The banking entity must take any additional steps required by the federal regulators to ensure that it is, in fact, not liable for any fund losses.

8. When engaging in any transactions with the covered fund, the banking entity must comply with certain restrictions (as discussed below).[54]

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[49] The Agencies explained that this exemption also applies to directors or employees who provide "services that enable the provision or investment advice or investment management, such as oversight and risk management, deal orientation, due diligence, administrative or other support services."

[50] The authority for such employees to invest in the fund is based on a similar "skin in the game" concept as the *De Minimis* Exception (i.e., it aligns the manager or adviser's incentives with those of the banking entity's customers).

[51] While numerous commenters on the Proposed Rule argued that the name-sharing prohibition should not apply with regard to banking entities that are an insured depository institution, the Agencies declined to provide such relief (suggesting that they were bound by the express statutory language of the Volcker Rule). Accordingly, the name of a covered fund that is sponsored by a banking entity must be dissimilar to that entity and *all* of its affiliates, including any serving as the fund's general partner or managing member.

[52] However, the Agencies indicated that a banking entity's issuance of a borrower default indemnification to a lending client in connection with a securities lending transaction involving a sponsored covered fund is not prohibited.

[53] Many banking entities that sponsor funds already include similar disclosure in the funds' offering documents. However, like the Proposed rule, the Final Rule appears to require that these two disclosures be given verbatim (with the insertion of the appropriate names).

[54] The Final Rule explicitly clarifies that the foregoing exemption also applies to sponsoring an ABS issuer, subject to the same rules (except that in such a case the requirements relating to the offering of bona fide trust, fiduciary, investment advisory, or commodity trading advisory services would not apply).

C. When Is a Non-U.S. Banking Entity Exempt from the Foregoing Requirements?

The same exemption for activity occurring "solely outside the United States" discussed above in the context of acquiring covered fund ownership interests applies to sponsorship of covered funds. Thus, an "eligible banking entity" (as discussed above) may sponsor an "eligible covered fund," provided the sponsorship is deemed to occur "solely outside the United States" (each as discussed above).

1. For the purpose of determining whether the activity satisfies the "solely outside the United States" requirement, the Agencies have indicated that the U.S. personnel of a non-U.S. banking entity may provide investment advice and recommendations to the manager or general partner of a covered fund so long as that investment advisory activity in the United States does not result in the U.S. personnel participating in the control of the covered fund or offering or selling an ownership interest to a resident of the United States.

D. What Rules Apply to Transactions Between a Banking Entity and any Fund It Organizes and Offers?

The Final Rule imposes the following new rules on any transactions between a banking entity (or any of its affiliates) and (1) any covered fund for which such entity serves as sponsor, investment manager, investment adviser or commodity trading adviser, or which it otherwise organizes and offers;[55] or (2) any fund controlled by such fund:

1. Market Terms Requirement — A banking entity (and its affiliates) may not provide any services or sell any assets to a such a covered fund, except as consistent with Section 23B of the Federal Reserve Act ("Section 23B").[56] As applied by the Final Rule, Section 23B requires that such transactions be conducted on terms, and under circumstances, that are at least as favorable to the banking entity as those prevailing at the time for comparable transactions involving unaffiliated companies.

   (a) If no relevant market terms exist, then the transaction must be on terms, and under circumstances, that in good faith would be offered by the banking entity to nonaffiliates.

2. Prohibited Transactions — Except as provided below, a banking entity may not enter into any transaction with such a covered fund, if the transaction would constitute a "covered transaction" as defined in Section 23A of the Federal Reserve Act ("Section 23A").[57] In this context, "covered transactions" under Section 23A would include:

   (a) Loans and other extensions of credit to the fund (including any purchase of assets subject to agreement to repurchase);

   (b) A purchase of, or an investment in, securities issued by the fund (except that acquisition or retention of ownership securities issues by the fund in a manner that is otherwise permitted by the Final Rule would not be prohibited);

   (c) A purchase of assets from the fund (other than such purchases of real and personal property as may be specifically exempted by the Board by order or regulation);

   (d) The issuance of a guarantee, acceptance, or letter of credit (including an endorsement or standby letter of credit) on behalf of the fund; and

[55] This requirement applies even where the services provided to the covered fund were not themselves subject to the Final Rule's sponsorship prohibition (i.e., where the relationship does not constitute sponsoring or is otherwise exempt from the prohibition).

[56] By its terms Section 23B only applies to transactions between a banking entity that is a member of the Federal Reserve System ("member bank") and any of its affiliates. However, for this purpose, the Volcker Rule applies Section 23B as if: (i) the banking entity transacting with the covered fund were a member bank; and (ii) the fund were an affiliate of such banking entity.

[57] Like Section 23B, Section 23A only applies to transactions between a member bank and any of its affiliates. However, the Volcker Rule applies Section 23A on the same basis as Section 23B (as discussed above). Moreover, while Section 23A normally merely imposes certain qualitative requirements and quantitative limits on "covered transactions" the Volcker Rule prohibits them outright. Because the Volcker Rule, expands the scope of entities to which Section 23A applies and replaces its requirements/limits with a prohibition, the Volcker Rule's application of Section 23A has been commonly referred to as "Super 23A."

(e) A securities lending, securities borrowing or derivative transaction with the fund, to the extent it caused the banking entity to have credit exposure to the fund.[58]

3. Prime Brokerage Transactions — The foregoing prohibition of covered transactions does not apply to "prime brokerage transactions" with a covered fund in which a covered fund sponsored, managed or advised by the banking entity (or an affiliate thereof) invests (however, such transactions would remain subject to the Section 23B requirements discussed above).[59]

   (a) Scope — Under the Final Rule, a "prime brokerage transaction" is defined as "any transaction that would be a covered transaction [under Section 23A], that is provided in connection with custody, clearance and settlement, securities borrowing or lending services, trade execution, financing, or data, operational, and administrative support."

   (b) Prerequisites — This exemption is available only so long as: (i) the chief executive officer (or equivalent officer) of the banking entity[60] certifies annually that the banking entity does not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of the covered fund or of any covered fund in which such fund invests; and (ii) the Board has not determined that the relevant transaction is inconsistent with the banking entity's safety and soundness.

III. OTHER PROHIBITED ACTIVITIES

Notwithstanding any of the foregoing, a banking entity may not engage in any activity or transaction with a covered fund, otherwise permitted under the Final Rule, if such activity or transaction would:

A. Involve a "material conflict of interest" between the banking entity and its clients, customers or counterparties;

   1. Unless, prior to engaging in such activity or transaction, the banking entity: (i) gives the other party clear and effective disclosure of the conflict and the opportunity to negate or substantially mitigate its impact; or (ii) the banking entity has information barriers that are reasonably designed to prevent a materially adverse effect on the other party (except where the banking entity knows, or should reasonably know, that the barriers are unlikely to prevent a particular materially adverse effect);

B. Materially expose the banking entity to an asset, group of assets or trading strategy that would significantly increase the likelihood of: (i) substantial loss by the banking entity; or (ii) a threat to the financial stability of the United States; or

[58] Section 23A and its implementing regulation contain several exemptions that excuse certain covered transactions from some of the requirements of Section 23A. While numerous commenters on the Proposed Rule argued that such exemptions should be incorporated into Super 23A, the Agencies disagreed because the statutory language of the Volcker Rule makes no reference to such exemptions when it incorporates the "covered transaction" definition from Section 23A. However, on another issue, the Agencies' strict reading of the Volcker Rule's incorporation of Section 23A worked to the benefit of banking entities. The Agencies noted that the statutory language only prohibits covered transactions *with a covered fund*. Thus, while Section 23A and its implementing regulation treat certain transactions between a bank an unaffiliated third party as covered transactions — where an affiliate is a known beneficiary of the transaction — Super 23A does not prohibit such transactions. Accordingly, for example, a banking entity is permitted to extend credit to a customer where such lending is secured by shares of a covered fund that the entity organizes and offers (including pursuant to a margin account), even though such a transaction would ordinarily be considered a covered transaction under Section 23A.

[59] It is important to note that this exception for prime brokerage transaction does *not* apply to transactions with the covered fund sponsored, managed or advised by the banking entity, *only* to transactions with a "second-tier" covered fund (i.e., one in which the first fund invests). However, for reasons apart from the Volcker Rule many banking entities already do not serve as primer broker for the funds they organized and offer.

[60] In the case of the U.S. operations of a non-U.S. banking entity, the senior officer of its U.S. operations may provide the required attestation.

C. Pose a threat to the safety and soundness of the banking entity or the financial stability of the United States.[61]

IV. TIMING

A. Conformance Date — Banking entities will have until July 21, 2015 to conform their activities to the Final Rule.[62] This deadline represents a one-year extension of the Volcker Rule's conformance period, which the Board granted simultaneously with the issuance of the Final Rule.[63]

B. Conformance Period Obligations — Between now and July 21, 2015, each banking entity is expected to engage in "good-faith efforts" to conform its activities and investments to the requirements of the Volcker Rule and the Final Rule, including developing and implementing the compliance program requirements of the Final Rule.[64] The Board has explained that such good faith efforts should include "evaluating the extent to which the banking entity is engaged in activities and investments that are covered by [the Volcker Rule] and the [Final Rule], as well as developing and implementing a conformance plan that is appropriately specific about how the banking entity will fully conform all of its covered activities and investments by the end of the conformance period."

C. Potential Extensions — Under the Volcker Rule, the Board empowered to grant a banking entity up to three one-year extensions. As indicated above, the Board has now used one of those potential extensions to grant the entire industry a one-year delay of the conformance date. Thus, a banking entity could potentially seek up to two additional one-year extensions.[65] Additionally, the Board may *further* extend the conformance date, up to an additional five years, for the acquisition or retention of an ownership interest in any "illiquid fund," if (i) such investment was made or contractually obligated by May 1, 2010 and (ii) the banking does not have the contractual right to terminate the investment or commitment.[66]

1. However, the Board cautioned that a banking entity "should not expand activities or make investments during the conformance period with an expectation that additional time to conform those activities or investments will be granted."

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[61] These are necessarily subjective analyses that a banking entity will have to undertake, but that will ultimately be judged (often with hindsight) by its primary federal regulator.

[62] Notwithstanding the foregoing, a company that was not a banking entity on July 21, 2010, must bring its activities into conformance before the later of (i) July 21, 2015 or (ii) two years after the date on which the company becomes a banking entity.

[63] In doing so, the Board indicated that it will continue to monitor developments to determine whether additional extensions of the conformance period would be in the public interest and consistent with the statute.

[64] The compliance program obligations imposed by the Final Rule will be covered by a future SRZ *Alert*.

[65] Any extension request must be submitted in writing at least 180 days in advance and must contain a detailed explanation of the banking entity's plan for divesting or conforming the activity, as well as an analysis of numerous factors required by the Board.

[66] In other words, the conformance date for investments in "illiquid funds" could be extended to, as late as, July 21, 2022. An "illiquid fund" is a covered fund that, as of May 1, 2010, was principally invested in "illiquid assets" (as defined by the Board), or was invested in, and contractually committed to principally invest in, illiquid assets; and (ii) makes all investments pursuant to, and consistent with, an investment strategy to principally invest in illiquid assets.

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